

## **REPORT OF THE AUDITOR-GENERAL TO THE EASTERN CAPE PROVINCIAL LEGISLATURE AND THE COUNCIL ON THE NELSON MANDELA BAY METROPOLITAN MUNICIPALITY**

### **REPORT ON THE CONSOLIDATED FINANCIAL STATEMENTS**

#### **Introduction**

1. I have audited the consolidated and separate financial statements of the Nelson Mandela Bay Metropolitan Municipality and its subsidiary set out on pages 241 to 359, which comprise the consolidated and separate statement of financial position as at 30 June 2012, the consolidated and separate statement of financial performance, statement of changes in net assets and the statement of cash flows for the year then ended, and the notes, comprising a summary of significant accounting policies and other explanatory information.

#### **Accounting officer's responsibility for the consolidated financial statements**

2. The accounting officer is responsible for the preparation and fair presentation of these consolidated and separate financial statements in accordance with South African Standards of Generally Recognised Accounting Practice (SA Standards of GRAP) and the requirements of the Municipal Finance Management Act of South Africa, 2003 (Act No.56 of 2003) (MFMA), the Division of Revenue Act of South Africa, 2010 (Act No. 6 of 2011, as amended) (DoRA), and for such internal control as the accounting officer determines is necessary to enable the preparation of consolidated and separate financial statements that are free from material misstatement, whether due to fraud or error.

#### **Auditor-General's responsibility**

3. My responsibility is to express an opinion on these consolidated and separate financial statements based on my audit. I conducted my audit in accordance with the Public Audit Act of South Africa, 2004 (Act No. 25 of 2001) (PAA), the general notice issued in terms thereof and International Standards on Auditing (ISAs). Those standards require that I comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated and separate financial statements are free from material misstatement.
4. An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated and separate financial statements. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the consolidated and separate financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation of the consolidated and separate financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an

opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated and separate financial statements.

5. I believe that the audit evidence I have obtained is sufficient and appropriate to provide a basis for my qualified audit opinion.

### **Basis for qualified opinion**

#### **Irregular expenditure**

6. Due to inadequate record keeping and staffing capacity issues within the supply chain management (SCM) unit, I was unable to obtain sufficient appropriate audit evidence to confirm that contracts awarded, that resulted in expenditure in the current financial year, were made in accordance with the requirements of the SCM legislation.

No alternative audit procedures could be performed to obtain reasonable assurance that the expenditure incurred on these awards was not irregular.

Consequently, I was unable to determine whether any adjustment relating to the disclosure of irregular expenditure in note 44.2 to the consolidated financial statements was necessary.

7. Contracts were awarded based on preference points that were not calculated in terms of section 2 of the Preferential Procurement Policy Framework Act, 2000 (Act No.5 of 2000) (PPPFA) and its regulations.

Consequently, irregular expenditure in note 44.2 to the consolidated financial statements is understated by at least R149 054 and it is not practicable to determine the full extent of the understatement as a result of the number of awards made.

8. The allocations with respect to the Integrated Public Transport Systems (IPTS) grant were not utilised solely for the purpose stipulated in the grant framework as required by section 15(1) of the DoRA.

Consequently, irregular expenditure in note 44.2 to the consolidated financial statements is understated by at least R5,9 million and the full extent of the understatement is impracticable to determine as a result of the volume of transactions processed in respect of the grant.

9. Procurement of goods and services was deliberately split into parts or items of smaller value to avoid complying with the requirements of SCM regulations 19(a) and 36(1).

Consequently, irregular expenditure in note 44.2 to the consolidated financial statements is understated by at least R4,4 million and the full extent of the understatement is impracticable to determine as a result of the number of awards made.

### **Qualified opinion**

10. In my opinion, except for the possible effects of the matters described in the Basis for qualified opinion paragraphs, the consolidated and separate financial statements present fairly, in all material respects, the financial position of the Nelson Mandela Bay Metropolitan Municipality and its subsidiary as at 30 June 2012 and their financial performance and cash flows for the year then ended, in accordance with GRAP and the requirements of the MFMA and DoRA.

### **Emphasis of matters**

11. I draw attention to the matters below. My opinion is not modified in respect of these matters.

### **Significant uncertainties**

12. As disclosed in note 45 to the consolidated financial statements, the municipality is the defendant in a number of lawsuits to the value of R100 million. The municipality is currently opposing these claims, however, the ultimate outcome of these matters cannot currently be determined.
13. As disclosed in note 46.1 to the consolidated financial statements, the council has adopted the recommendations of the Kabuso Report (previously made public on 20 October 2011) on 8 December 2011. The recommendations of the report are in the process of implementation to deal with the possible unauthorised, irregular and fruitless and wasteful expenditure.

### **Restatement of corresponding figures**

14. As disclosed in notes 40 and 41 to the consolidated financial statements, the comparative figures for 30 June 2011 have been restated as a result of a change in accounting policy and errors discovered during the financial year ended 30 June 2012 in the financial statements of the municipality at, and for the year ended, 30 June 2011.

### **Unauthorised, irregular and fruitless and wasteful expenditure**

15. As disclosed in note 44 to the consolidated financial statements, R557,2 million of unauthorised, irregular and fruitless and wasteful expenditure was incurred during the financial year.
16. Unauthorised expenditure amounting to R318,7 million was incurred due to overspending in respect of a number of votes within the approved municipal expenditure budget.
17. Irregular expenditure amounting to R234 million was incurred which related to contraventions of the SCM requirements.

18. Fruitless and wasteful expenditure amounting to R4,5 million was incurred due to the breach of contractual agreements and would have been avoided had reasonable care been exercised.

#### **Transfer of functions**

19. As disclosed in note 46.2 to the consolidated financial statements, the operations of the primary health care function are due to be transferred to the provincial Department of Health on 1 July 2012. The function has been accounted for in terms of a discontinued operation. The disposal group comprises all revenue, expenses, assets and liabilities attributable to the provision of health care services.

#### **Material losses/ Impairments**

20. As disclosed in note 28 to the consolidated financial statements, bad debts expenditure amounted to R257 million. This is due to bad debt write-offs of R251 million and an increase in the provision for doubtful debts by R6 million.
21. As disclosed in note 35.7 to the consolidated financial statements, an impairment expense of R93 million had been incurred against the "new billing system" due to future service potential no longer being foreseen. The comparative information for fruitless and wasteful expenditure as disclosed note 44 to the consolidated financial statements has been restated to include this amount.
22. As disclosed in note 35.11 to the consolidated financial statements, water losses of 19 272 megalitres (21%) amounting to R127,2 million were incurred during the financial year.

#### **Material under-spending of the budget**

23. As disclosed in note 53 to the consolidated financial statements, the municipality has under-spent on its capital budget by R137,7 million. This is further reflected in note 9 to the consolidated financial statements depicting the level of unspent conditional grants at year-end.

#### **Additional matter**

24. I draw attention to the matter below. My opinion is not modified in respect of this matter

#### **Unaudited supplementary schedules**

25. The supplementary information set out on pages 358 to 359 does not form part of the consolidated financial statements and is presented as additional information. I have not audited these schedules and, accordingly, I do not express an opinion thereon.

### **Withdrawal from the audit engagement**

26. A number of misstatements have been identified in the consolidated financial statements. This, in addition to the limitations imposed on the audit and the significant amount of investigations into alleged irregularities at the municipality, is indicative of possible fraud which calls into question the reliability of evidence obtained and the credibility of the accounting records and documentation. But for the legislated requirement to perform the audit of the municipality I would have withdrawn from the engagement in terms of the ISAs.

### **REPORT ON OTHER LEGAL AND REGULATORY REQUIREMENTS**

27. In accordance with the PAA and the general notice issued in terms thereof, I report the following findings relevant to performance against predetermined objectives, compliance with laws and regulations and internal control, but not for the purpose of expressing an opinion.

#### **Predetermined objectives**

28. I performed procedures to obtain evidence about the usefulness and reliability of the information in the annual performance report as set out on pages 13 to 171 of the annual report.
29. The reported performance against predetermined objectives was evaluated against the overall criteria of usefulness and reliability. The usefulness of information in the annual performance report relates to whether it is presented in accordance with the National Treasury's annual reporting principles and whether the reported performance is consistent with the planned objectives. The usefulness of information further relates to whether indicators and targets are measurable (i.e. well defined, verifiable, specific, measurable and time bound) and relevant as required by the National Treasury *Framework for managing programme performance information* (FMPPI).

The reliability of the information in respect of the selected objectives is assessed to determine whether it adequately reflects the facts (i.e. whether it is valid, accurate and complete).

30. There were no material findings on the annual performance report concerning the usefulness and reliability of the information.

#### **Additional matter**

31. Although no material findings concerning the usefulness and reliability of the performance information were identified in the annual performance report, I draw attention to the following matter below. This matter does not have an impact on the predetermined objectives audit findings reported above.

### **Achievement of planned targets**

32. As reported in the annual performance report, only 60% of the planned targets were achieved during the year under review. The main reasons for the under-achievement were the delays in receipt of funding, a reduction in grant funding received and poor implementation of the budget and inadequate performance monitoring.

### **Compliance with laws and regulations**

33. I performed procedures to obtain evidence that the entity has complied with applicable laws and regulations regarding financial matters, financial management and other related matters. My findings on material non-compliance with specific matters in key applicable laws and regulations as set out in the general notice issued in terms of the PAA are as follows:

### **Annual financial statements**

34. The financial statements submitted for auditing were not prepared in all material respects in accordance with the requirements of section 122 of the MFMA.
35. Material misstatements identified by the auditors in the submitted financial statements were not adequately corrected and the supporting records could not be provided subsequently, which resulted in the financial statements receiving a qualified audit opinion.

### **Procurement and contract management**

36. Sufficient appropriate audit evidence could not be obtained that:
- goods and services of a transaction value above R0,2 million were procured by means of inviting competitive bids and/or that deviations were approved by the accounting officer only if it was impractical to invite competitive bids, as required by SCM regulation 19(a) and 36(1)
  - invitations for competitive bidding were advertised for a required minimum period of days, as required by SCM regulation 22(1) and 22(2)
  - bid specifications for procurement of goods and services through competitive bids were drafted in an unbiased manner that allowed all potential suppliers to offer their goods or services, as per required by SCM regulation 27(2)(a)
  - bid specifications were drafted by bid specification committees which were composed of one or more officials of the municipality as required by SCM regulation 27(3)

- contracts were awarded to bidders based on points given for criteria that were stipulated in the original invitation for bidding, as required by SCM Regulations 21(b) and 28(1)(a) and Preferential Procurement Regulations
  - bids were evaluated by bid evaluation committees which were composed of officials from the departments requiring the goods or services and at least one SCM practitioner of the municipality as required by SCM regulation 28(2)
  - bid adjudication was always done by committees which were composed in accordance with SCM regulation 29(2)
  - the preference point system was applied in all procurement of goods and services above R30 000 as required by section 2(a) of the Preferential Procurement Policy Framework Act, 2000 (Act No.5 of 2000) (PPPFA) and SCM regulation 28(1)(a)
  - contracts were awarded to bidders that scored the highest points in the evaluation process, as required by of section 2(1)(f) of PPPFA
  - contracts were only extended or modified after tabling the reasons for the proposed amendment in the council of the municipality, as required by section 116(3) of the MFMA
  - all extensions or modifications to contracts were approved by a properly delegated official, as required by SCM regulation 5
  - construction contracts were awarded to contractors that were registered with the Construction Industry Development Board (CIDB) and qualified for the contract in accordance with section 18(1) of the Construction Industry Development Board Act, 2000 (Act No. 38, 2000) (CIDB Act) and CIDB regulations, 2004 17 and 25(7A)
  - contracts were only awarded to providers whose tax matters have been declared by the South African Revenue Service to be in order as required by SCM regulation 43
  - contracts were awarded only to bidders who submitted a declaration on whether they are employed by the state or connected to any person employed by the state, as required by SCM regulation 13(c)
  - all contracts were awarded in accordance with the legislative requirements and a procurement process which is fair, equitable, transparent and competitive, as the requested tender files could not be provided for audit purposes within the agreed time frames due to inadequate record keeping and the significant number of vacancies within the SCM unit
37. Contracts and quotations were awarded to bidders based on preference points that were not calculated in accordance with the requirements of section 2 of the PPPFA and its regulations.
38. Construction contracts entered into by the municipal entity were not always registered with the CIDB, as required by section 22 of the CIDB Act and CIDB regulation 18.
39. Goods and services of a transaction value above R200 000 were procured without inviting competitive bids as per the requirements of SCM regulation 19(a) and 36(1).

40. Awards were made to providers who are persons in the service of the municipality in contravention of SCM regulations 44.
41. Awards were made to providers who are persons in the service of other state institutions, in contravention of SCM regulations 44. Similar awards were identified in the prior year and no effective steps were taken to prevent or combat the abuse of the SCM process in accordance with SCM regulation 38(1).

### **Expenditure management**

42. Money owing by the municipality was not always paid within 30 days of receiving an invoice or statement, as required by section 65(2)(e) of the MFMA.
43. The accounting officer did not take effective steps to prevent unauthorised expenditure, irregular expenditure and fruitless and wasteful expenditure, as required by section 62(1)(d) of the MFMA.
44. An adequate management, accounting and information system was not in place which recognised expenditure when it was incurred and accounted for creditors as required by section 65(2)(b) of the MFMA.

### **Human resource management**

45. Three acting senior managers were appointed for periods exceeding six months, in contravention of section 56(1)(c) of the Municipal Systems Act, 2000 (Act No. 32 of 2000).

### **Conditional grants**

46. The municipality did not submit MFMA implementation plans to the National Treasury to address weaknesses in financial management, as required by the Division of Revenue Grant Framework, Gazette No.34280.

### **Asset management**

47. All investments were not made in accordance with the requirements of the investment policy, as required by Municipal Investment Regulation 3(3) as investments held at certain financial institutions exceeded 25% of the investment portfolio of the municipality.



**Internal control**

48. I considered internal control relevant to my audit of the financial statements, annual performance report and compliance with laws and regulations. The matters reported below under the fundamentals of internal control are limited to the significant deficiencies that resulted in the basis for qualified opinion and the findings on compliance with laws and regulations included in this report.

**Leadership**

49. There is a serious lack of permanent and committed leadership within the municipality. This lack of guidance and ultimate instability has filtered through the key functional areas of the institution, resulting in a lack of accountability for poor performance.
50. The leadership failed to maintain the integrity of their system of internal control by not ensuring its enforcement as a result of vacancies at management level. Certain employees in acting positions do not necessarily have the required skills and knowledge and are often not in the position long enough to instil the values of the municipality within the function they are managing.
51. This lack of stable leadership contributed to the significant amount of irregular expenditure incurred.
52. Key staff members are overloaded and do not have sufficient capacity to assist with the audit process throughout the year. This matter is further aggravated due to a lack of a succession plan while these key members are not available.
53. Certain staff members employed in the accounting function do not have sufficient working knowledge of the underlying system and the applicable financial reporting framework.
54. There is an apparent lack of detailed standard operating procedure documents within the municipality. The evidence provided does not adequately deal with the day-to-day running and guidance of the municipality and its staff members (both new and existing).
55. This is a lack of commitment by the leadership to monitor the implementation of action plans to address internal control deficiencies identified by both internal and external audit.
56. Poor implementation of the budget and inadequate performance management resulted in the non-achievement of 40% of the annual performance targets of the municipality.
57. The budgetary process does not take into account the full extent of the non-cash flow items resulting in the over-spending of the approved municipal budget.

**Financial and performance management**

58. Due to the number of vacancies within the SCM unit, there was a lack of staff to check that the systematic filing method in place for the record keeping of SCM documentation was applied effectively. The majority of requested documentation could not be supplied within the required time frames and as a result the existence of the documentation and occurrence of the transactions could not be confirmed.
59. All creditors are not reconciled due to a lack of receipt of statements. There are inadequate supervisory checks over the creditors reconciliations as a number of errors supporting this have been identified.
60. There is no central point for receipt of invoices, ensuring that all invoices received have been processed, which contributed to delays between the time an invoice is received and the time it is submitted to the creditors department for payment to suppliers.
61. Certain journal vouchers do not contain sufficient supporting documentation to ensure the accuracy and validity of the entries being passed. Persons responsible for the review of journals do not necessarily return journals with inadequate supporting documentation to those who are responsible for the preparation thereof prior to authorisation.
62. Reconciliations of assets and liabilities are performed; however, reconciling items are not always addressed, followed up on nor resolved timeously.
63. The financial statements are not subject to a detailed independent review prior to submission for audit purposes.

**Governance**

64. A risk assessment was conducted by the municipality and a risk strategy which included a fraud prevention plan was prepared. The risks identified by management were, however, not adequately matched with the appropriate internal controls of the municipality; which contributed to the internal control deficiencies identified during the audit.
65. There is a lack of commitment by the leadership to adequately response to the internal control deficiencies identified by internal audit.
66. The audit committee made numerous recommendations during the year under review to the accounting officer and the mayor relating to the evaluation and monitoring of responses to risk and weaknesses in the internal control environment. However, these recommendations are not adequately acted upon.

**OTHER REPORTS****Investigations**

67. As disclosed in note 44 to the consolidated financial statements, investigations into several alleged transgressions are currently in progress and may result in unauthorised, irregular or fruitless and wasteful expenditure.
68. Nineteen investigations, eight of which relate to SCM, were still in progress at year-end. Twenty investigations, three of which related to SCM, were completed during the year. The irregular expenditure relating to these investigations is included in note 44.2 to the consolidated financial statements.



East London

7 December 2012



AUDITOR - GENERAL  
SOUTH AFRICA

*Auditing to build public confidence*